



**EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503**

August 30, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: J. Gregory Ballentine

SUBJECT: Inflation, the Cycle, and the Dollar

Recent Inflation Figures

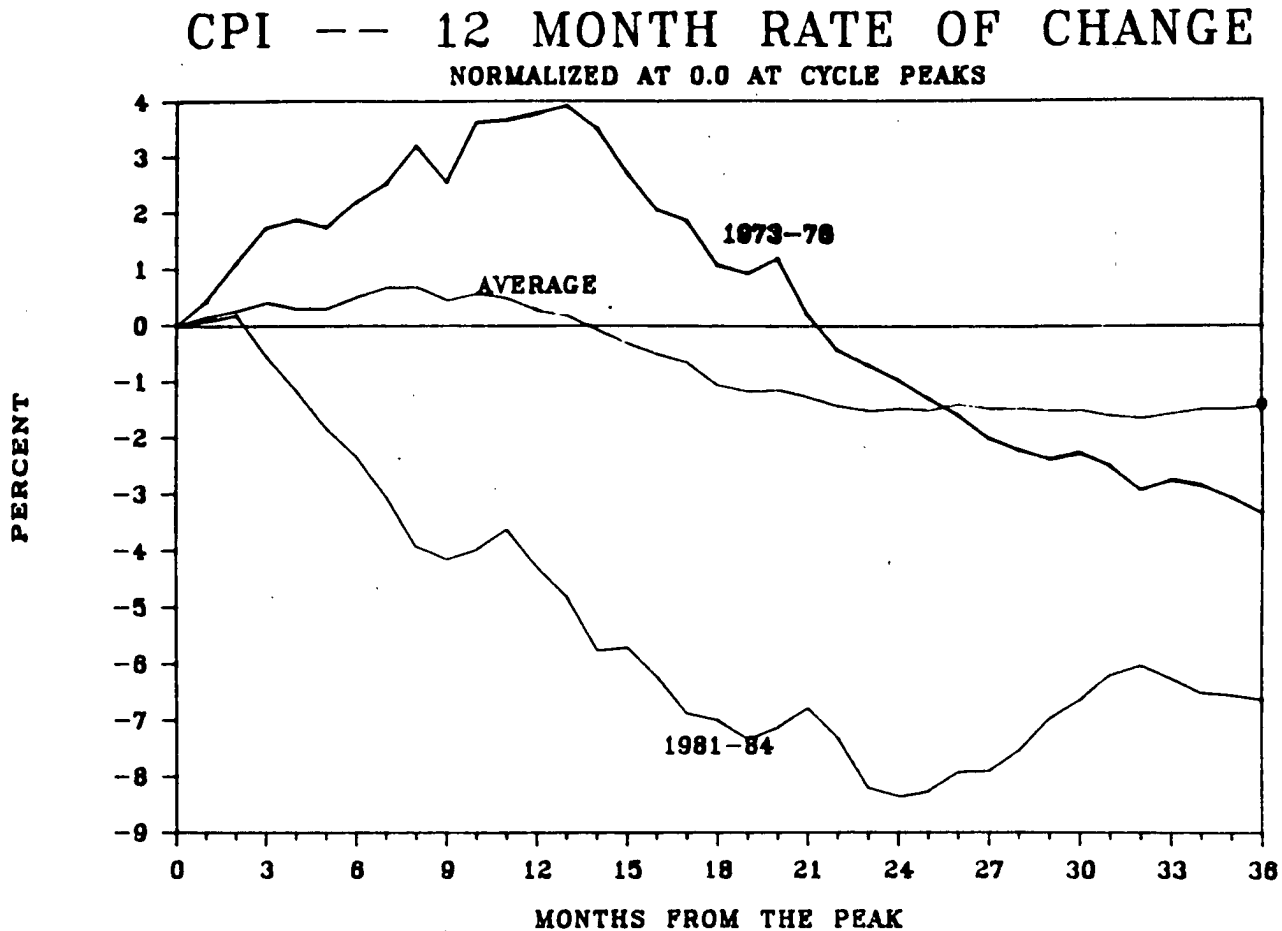
- o In comparison with the inflation rates of the late 1970s and 1980, the recent inflation figures have been very good.
 - The GNP deflator for Q2/84 rose at an annual rate of 3.2%. In Q1/84 and Q4/83 the deflator rose 4.4%.
 - The CPI has risen 4.2% over the last 12 months and the monthly rate (annualized) for July is only 3.7%.
- o Overall, these figures give a picture of approximately 4% inflation.
- o These recent numbers must however be interpreted in light of many factors, including:
 - The stage we are in in the business cycle.
 - The rising value of the dollar.

Inflation Patterns Over the Cycle

- o Typically, inflation continues to rise even after a recession has begun. It takes some time for the economy to weaken enough to cause inflation to decline.

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- o This pattern did not emerge in the recent recession, inflation was already declining when the recession began.

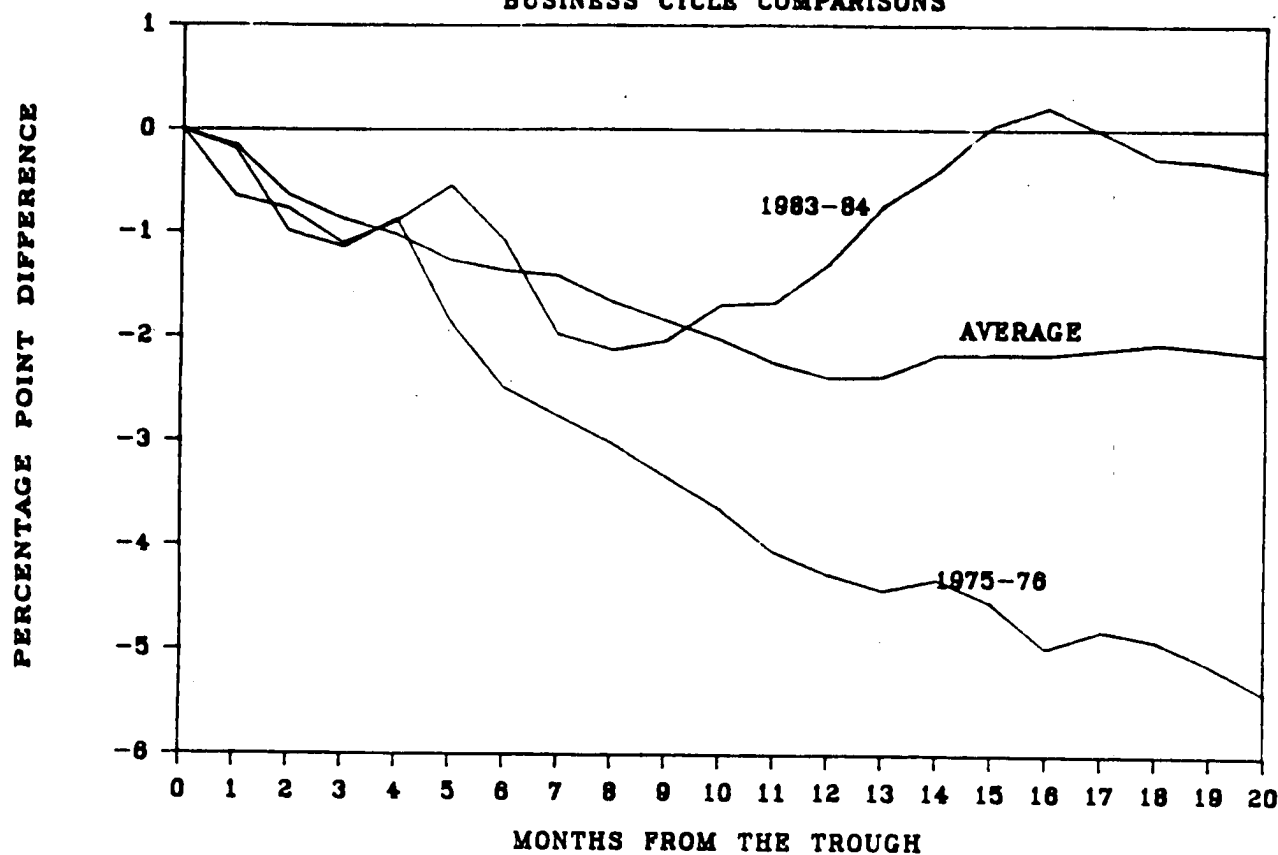


- o Certainly the major reason that inflation fell so quickly in the recent recession is that there was virtually no recovery from the 1980 recession. In fact, there was almost a continuous recession from January 1980 to November 1982.
- o It is also typical for inflation to continue to fall (or not to rise) throughout the year and a half after the trough of the recession.
- o In the most recent recovery, however, the CPI has begun to rise after less than a year of recovery and other inflation indicators stopped a clear decline at about that time.

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12 MONTH CHANGE IN THE CPI

BUSINESS CYCLE COMPARISONS

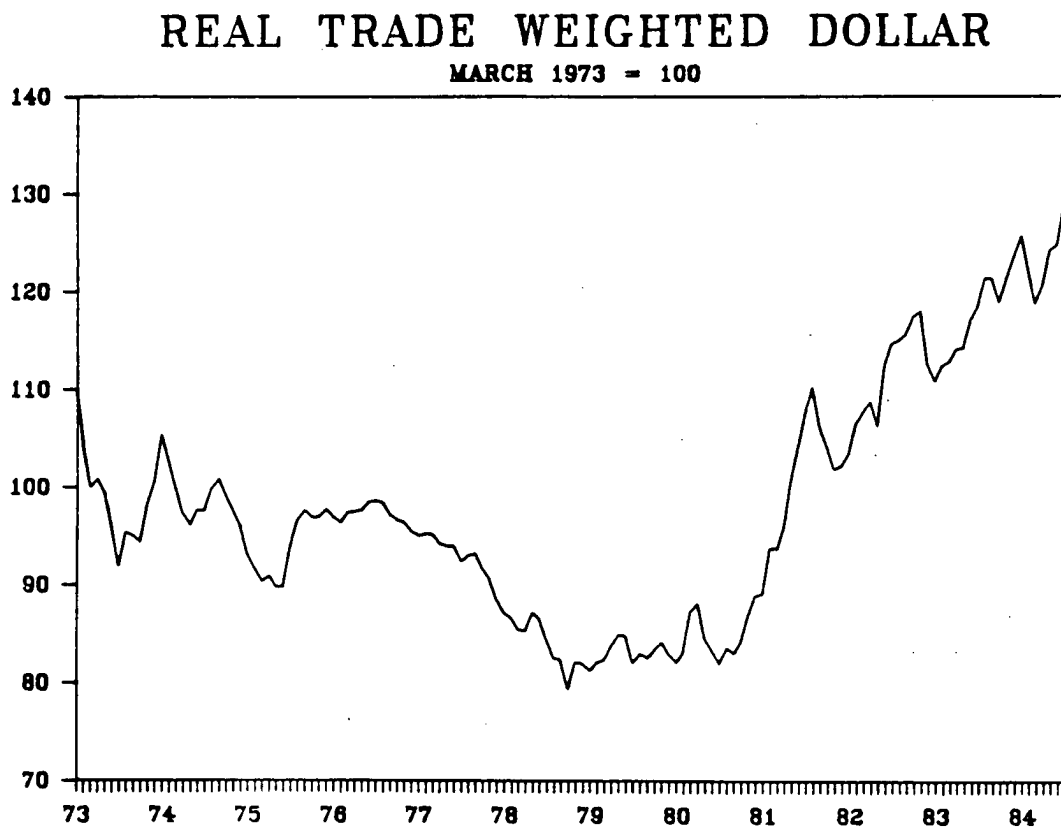


- o This strongly suggests that we have now gained all of the inflation benefits that will come from the monetary restraint of 1981 and the consequent weak economy of 1980-82.
- o A renewal of the decline in inflation, or even a continuation of inflation at the current level, will require a steady decline in the growth rate of money over the next few years.

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Recent Levels of Inflation and the Rising Dollar

- o By 1981 the rise in the real value of the dollar that began in late 1980, had fully offset the decline of the dollar during the late 1970s, and since early 1982 the dollar has risen another 30%.



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- o The real value of the dollar has a direct impact on the real price of imported commodities. If the real value of the dollar rises, the real cost of imports tends to decline.
- o A rise in the real value of the dollar resulting from United States policy changes or exogenous changes abroad can be a favorable inflation shock much like the oil price increases in the 1970's were unfavorable price shocks.
- o In fact, the almost 50% rise in the real value of the dollar is comparable in size to the oil price shock of 1979.
- o Ignoring offsetting changes in monetary policy, an exogenous 10% rise in the real value of the dollar will, with a lag, reduce the increase in the CPI by 1 to 1.5 points.
 - Since imports comprise about 10% of GNP, a 10% rise in the real value of the dollar initially tends to lower the CPI by 1%.
 - Importers tend to capture some of the price fall by raising the foreign price of the imported good leaving only about a 0.5% initial fall in the CPI.
 - A further drop of 0.5 to 1.0 in the CPI occurs more slowly as domestic prices rise less in order to compete with imports.
- o Consequently, the recent rise in the real value of the dollar (8% over the last year) on top of the dramatic previous rise may have lowered the inflation rate over the period 1981-84 by about 8 points and over the most recent year by about 1 percentage point.
- o This means that unless the dollar keep rising, the inflation problem we face now may be more on the order of 5% than 4%.
- o Further, it may be that part of the rise in the dollar has been due to expectations that we would pursue policies to further lower inflation; if those policies are not carried out such expectations may change and the dollar could fall adding to inflationary pressures.



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August 31, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

From: Beryl W. Sprinkel *Beryl W. Sprinkel*
Subject: The Outlook for the Economy and Monetary Policy

There are increasing signs that the pace of the economic expansion is moderating. This is generally good news for the financial markets. Early in the year there was widespread concern in the financial markets that the economy was growing so rapidly that an acceleration of inflation was inevitable. Those fears helped push long-term interest rates up between February and June. There was also a general expectation in the financial markets that these same concerns about rapid real growth and inflation would lead the Federal Reserve to tighten monetary policy. This speculation put upward pressure on short-term interest rates as well.

As the recovery continued into the summer and the price indices showed no significant acceleration of inflation, fears about future inflation subsided appreciably. Most surveys of inflation expectations have improved dramatically over the summer; one survey taken in June and again in August shows a sharp decline in inflationary expectations over all time horizons. The improvement in inflation expectations is reflected in a decline in long-term interest rates of about 100-150 basis points since late June/early July.

Inflationary concerns have also been allayed by the fact that money growth has been well-behaved so far in 1984. Relative to the fourth quarter 1983 average, M1 grew at an annual compound rate of 6.5% through July; with the exception of a few weeks in the March/April period, the level of M1 has generally remained within the upper half of its target range. During the first half of the year the concern about accelerating inflation and the speculation about Fed tightening (and the resultant effects on interest rates) would have been heightened considerably, if money growth had been higher and/or above its target range. In contrast, moderate and relatively stable money growth helped contain these expectations effects on interest rates.

The decline in long-term rates over the past two months has not been matched by a decline in short-term rates. This has led to some flattening of the yield curve over the summer.

Many analysts have attributed the failure of short rates to fall to the strength of business demand for credit and risks associated with problem financial institutions, as well as speculation about Fed tightening moves.

Earlier in the year, most private analysts were forecasting rising interest rates throughout 1984. Over the summer, more and more private forecasters began foreseeing stable, or modest declines, in rates during the second half of 1984. This change in outlook primarily reflects the downward adjustment in inflation expectations, evidence that the rate of economic expansion is moderating, and initial signs that the growth of private credit demand may be abating.

We should expect -- and welcome -- some slowing in the pace of economic activity. The declines in the index of leading indicators in June and July are foreshadowing a deceleration in the pace of economic recovery. If money growth continues to be moderate, inflation expectations should continue to adjust downward as the real economy settles into a sustainable rate of expansion. In addition, a moderation in the rate of economic growth can be expected to relieve some of the upward pressure on short-term interest rates.

In short, most of the worst-case scenarios that were potential threats to the economy earlier in the year have generally not materialized. While the economic expansion appears to be slowing down, there is no indication of an unacceptable slowdown, or decline, in economic activity as some had foreseen. While we can expect some acceleration in the rate of inflation -- and the Administration and the Federal Reserve must be vigilant to the threat of inflation -- wage and price pressures appear to remain subdued at the present time. While important progress has been made on the international debt situation, it, along with the financial difficulties of some major financial institutions, are important risks to continued economic growth and stability.

The major risk associated with monetary policy continues to be related to the operating procedures of the Federal Reserve. As we have discussed on many previous occasions, the Fed's day-to-day operating procedures are functionally equivalent to controlling the Federal funds rate. While this procedure may, as it has over the past six or eight months, result in appropriate money growth, the relationship between the Federal funds rate and money growth is generally not reliable or predictable.

Historically the Federal Reserve has failed to adjust its Federal funds rate target enough, or quickly enough, as market pressures on interest rates change. Thus the Fed lags behind and thereby resists market pressures on interest rates in either direction; the result is prolonged periods of too much or too little money growth. If there are downward market pressures on interest rates which the Fed does not recognize or act upon, it

will be in a position of propping rates up; the result is inadequate reserve and money growth. Conversely, if the Fed resists upward interest rate pressures in the market, the result is excessive reserve and monetary expansion. This is the source of what has historically been a highly procyclical monetary policy in the U.S., which has alternatively over-stimulated the economy during expansions and exaggerated, if not caused, economic downturns.

Despite the relatively good performance of the monetary aggregates this year, these risks persist because the Federal Reserve's approach to policy implementation has not changed.